

From: "Jane Stone" <jstone@ilfi.org> on 01/18/2006 03:15:01 PM

Subject: Risk-Based Capital Guidelines

January 18 , 2006

Office of the Comptroller of the Currency
250 E Street, S.W.
Mailstop 1-5
Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th St. & Constitution Ave., N.W.
Washington, DC 20551

Attention Docket No. 05-16
regs.comments@occ.treas.gov

Attention: Docket No. R-1238
regs.comments@federalreserve.gov

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

comments@FDIC.gov

Attention: No. 2005-40
regs.comments@ots.treas.gov

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital
Maintenance: Domestic Capital Modifications
70 FR 61068 (October 20, 2005)

Dear Mesdames and Sirs:

The Illinois League of Financial Institutions (ILFI) is a statewide banking trade association dedicated to furthering the viability of thrifts and community banks in Illinois.

ILFI is pleased to comment on the joint advance notice of proposed rulemaking ("ANPR") issued to solicit comments on changes to the risk-based capital framework for depository institutions in the United States. The revised framework would apply to those banks and savings associations that are not required to comply, and do not opt-in, to the revised Basel Capital Accord developed by the Basel Committee on Banking Supervision at the Bank for International Settlements ("Basel II"). This ANPR would lead to the issuance of a notice of proposed rulemaking at or near the time that the agencies also issue a notice of proposed rulemaking for Basel II.

Prior to assuming the post of President of the ILFI, I served as an Assistant Commissioner of the Illinois Office of Banks and Real Estate. As a banking regulator for more than 15 years, I observed numerous instances of across-the-board regulation and the unintended consequences of such actions. This approach and inflexible standards can penalize otherwise well-capitalized community based thrifts and banks. One unintended consequence would be to give large regional and multi-state banks an unfair advantage over smaller community based

entities. Another would be to force the smaller community based bank or thrift to ration credit to the community based not on the credit worthiness of the borrower but rather by the effect the transaction might have on the capital composition.

The ILFI wishes to thank the regulators for their support of a proposed Basel I-A. The competitive benefits for community banks provided by such a change are enormous. The opportunity to truly reflect the risk associated with a bank's assets is critical. Community banking is the backbone of commerce in this State. A practical understanding of the effects these capital guidelines would have on banking and thrift entities as well as a flexible implementation strategy are essential to the continued viability of these institutions.

COMMENTS ON SPECIFIC CAPITAL RULES

- ILFI supports adding more risk buckets based on loan-to-value ("LTV") ratios for one-to-four family residential mortgage loans. If other risk criteria, such as credit scores and debt-to-income ratios are to be included in a revised Basel I, it should be optional for those institutions that wish to incur additional burden in order to have capital requirements even more closely aligned with risk. We support the use of private mortgage insurance ("PMI") to reduce the numerator in the LTV ratio. There should not be different treatment for interest-only or other novel mortgage products.
- The risk criteria that should be taken into account to differentiate multifamily residential mortgages should be LTV ratios and number of units. A similar approach to the buckets for single-family residential mortgage loans should be used to stratify these mortgages based on risk.
- We agree that mortgages should be placed in buckets as recommended in the ANPR.
- We recommend that consumer loans (automobiles, boats, recreational vehicles, motorcycles, trucks, airplanes, and others) should be risk-weighted based upon LTV ratios. Collateral is the most reliable basis for determining risk and collection of debt once such an item is repossessed. In addition, the agencies should consider the use of loan term, credit scores and debt-to-income ratios for other types of unsecured retail loans. Use of these criteria to differentiate loans should be optional for Basel I banks.
- We believe that the use of nationally recognized statistical rating organizations would more properly identify risk within a bank's investment portfolio. We agree with the expanded eligible financial collateral and guarantor analysis in the ANPR.
- We believe that small business loans can be separated into two categories. The first category would include collateralized small business loans. Any such small business loan should be risk-weighted based upon the LTV of eligible collateral into several buckets. The second category would include non-collateralized small business loans. These loans could be risk-weighted on the credit assessment of the personal guarantors, terms of the loan, total dollar amount of the loans, amortizations schedules and past history of the borrower. Rather than place all of these into a 100% bucket, these loans should be risk-weighted into lower buckets, taking into consideration an analysis of the above factors.
- Loans 90 days or more past due or in non accrual status should not be placed in a high bucket. These loans should remain in the bucket according to their type. The allowance for loan and lease losses (ALLL) that banks must maintain already adequately addresses potential losses that may exist over collateral values. The LTV ratio must be considered. The ALLL formula requires all past-due and impaired assets to be individually analyzed for losses, and for amounts to be specifically set-aside in the allowance. Similarly, assigning a weighting of more than 100% to loans that are 90 days or more past due or in non-accrual status is not reasonable. Banks would be penalized

by such treatment.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.
- We believe that the leverage ratio may ultimately become unnecessary if the internal risk-weighting system is fully implemented. The countries of the European Union and others do not have a leverage ratio. The current parameters of the leverage ratio may need to remain in place for now, but a study should be done as to whether it should be lowered in the future.
- Depository institutions of any size that would prefer to remain subject to Basel I as it currently exists should have the option to do so. Also, institutions should be permitted to pick and choose the changes they would like to incorporate in their risk-based capital framework, depending on their choice to incur further burden to increase the risk sensitivity of their capital requirements.

BALANCE SHEET ITEMS NOT ADDRESSED IN THE ANPR

We would like to stress the importance of addressing every asset on a bank's balance sheet when finalizing the proposed formula for Basel I-A. The ANPR addresses some of the assets, but not all. Some of the missing ones that need to be addressed are:

- Commercial Real Estate Loans
- Bank Land and Building
- Interest-Earning Deposits (CDs) \leq \$100,000
- Correspondent Bank Deposits

Please consider our comments for approaching a change in methodology as follows:

- Commercial Real Estate Loans: These assets should be internally rated based upon loan-to-value (LTV) ratios. Currently these assets are weighted in the 100% bucket. Those commercial mortgages with LTV Ratios of $\leq 20\%$ could be in the 20% bucket; those with LTV Ratios of $\leq 40\%$ could be in the 35% bucket; those with LTV Ratios of $\leq 50\%$ could be in the 50% bucket; those with LTV Ratios of $\leq 75\%$ could be in the 75% bucket; and those with higher LTV Ratios could be in the 100% bucket. This methodology would be consistent with that used for mortgage loans with the common factor being an outside third-party appraisal.
- Bank Land and Buildings (Bank's Property): Currently, these assets are weighted in the 100% bucket. No mention of change of treatment for risk weighting has been noted in the ANPR for these assets. Value must be placed upon these assets and consideration must be given to measuring the book value of these assets against the appraisals done by independent consultants. The net book value of those assets $\leq 50\%$ of appraised value could be in the 20% bucket; the additional net book value of those assets $\leq 70\%$ could be in the 75% bucket; and the remainder of the net book value of those assets $\geq 70\%$ could be in the 100% bucket. Most bank properties are situated on prime locations and are well-maintained facilities. A sale of these assets would generally bring a profit and not a loss to the institutions. Risk-weighting modifications must be accomplished in this asset category.
- Interest-Earning Deposits (CDs) \leq \$100,000: Currently, these assets are

weighted in the 20% bucket. No mention of change of treatment for risk weighting has been noted in the ANPR for these assets. These interest-bearing deposits in other financial institutions are backed by the Federal Deposit Insurance Corporation. As a result, these assets should be risk-weighted in the 0% bucket. Any dollar amount above the \$100,000 limit should remain in the 20% bucket.

- Correspondent Bank Deposits: Currently, these assets are weighted in the 20% bucket. No mention of change of treatment for risk weighting has been noted in the ANPR for these assets. The first \$100,000 of deposits in each correspondent bank could be in the 0% bucket. The remainder could be kept in the 20% bucket.

Once again, thank you for the opportunity to comment on these extremely important capital guidelines. As you develop the rules, please be mindful of the ultimate consequences of the implementation of these guidelines. They will need to work for multi-national, nationwide and large regional banks just as they do for small banking entities. For our Illinois communities to continue to thrive, competition among the depository institutions needs to be fair. As we have pointed out repeatedly on this issue, the "one size fits all" approach of Basel II penalized smaller banking entities, clearly an unintended consequence. You have the opportunity to correct this with the adoption of a flexible Basel I-A approach. Your support in accomplishing this will be very much appreciated.

Please contact me if you have any questions.

Yours very truly,

Jay R. Stevenson
President
Phone 217-522-5575
Fax 217-789-9115
e-mail jstevenson@ilfi.org